

# Schroders Global Active Value Fund update

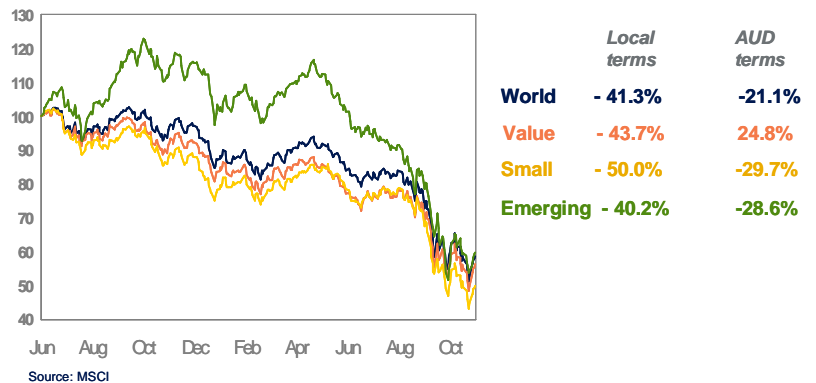
by David Philpotts, Senior Portfolio Manager

## International equities performance

It would be an understatement to say 2008 has been a challenging year, particularly for value strategies. Chart 1 shows the return of various market indices since 1 July 2007 and global equity markets have fallen dramatically across the board.

In local terms, that is ignoring the impact of exchange rates, the MSCI World index is down 41.3% while the Value style of investing has fared worse at -43.7%. Small caps have also been hit hard down 50%. Emerging markets initially held up well but have fallen back dramatically since April.

Chart 1: Performance of global equity markets: 30 June 2007 to 30 Nov 2008 (local returns)



For Australian investors, the impact of these declines would have been lessened for those in unhedged global equity products. Global returns in AUD terms have been approximately 20% better because of the massive depreciation of the AUD.

## Global Active Value strategy recap

A review of the three main building blocks of the Global Active Value strategy will assist to understand recent performance.

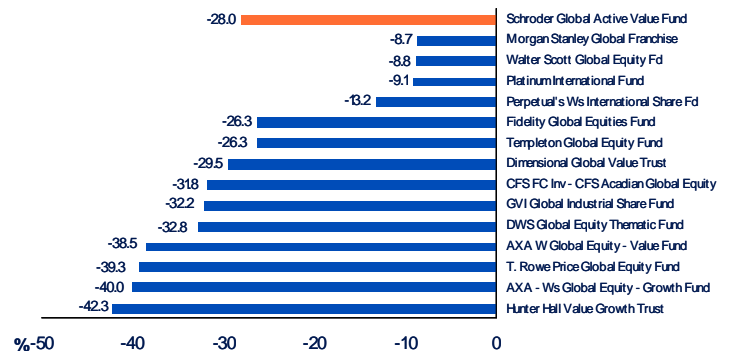
- A deep Value strategy: looking to buy cheap and sell expensive stocks. The value premium is to a large extent a risk premium and performs much better when there is a greater tolerance for risk. It's therefore pro-cyclical, underperforming in economic downturns and outperforming when markets recover.
- Benchmark unaware. Strategically the strategy avoids mega-cap stocks that lag behind on average.
- Exploits huge breadth and taps companies from both developed and emerging markets to maximise opportunity.

Global Active Value is a long term strategy and over the course of the cycle we would expect to make 3 to 4% above global cap weighted indices. However, as it is a benchmark unaware strategy and completely bottom-up, it can look very different to the benchmark in the short-run however and we should not be surprised by significant volatility in short-term relative performance.

## Performance and positioning

The absolute performance of Global Active Value as well as these other popular global equity products have struggled over the last 12 months. No-one has escaped the massive market sell off that has occurred. The underperformance of value based strategies in general is to a large extent a reflection of the economic backdrop. The scale of the relative performance given the bottom up nature of the fund is certainly not extreme or even unusual given the market environment.

Chart 2: Performance of popular global equity managers

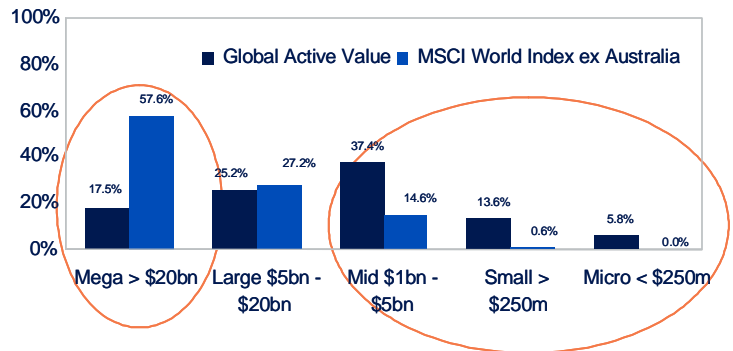


Source: Morningstar, As at 30 November 2008

Chart 3 shows just how large the Global Active Value strategy's anti-mega cap and pro small and mid cap exposures are compared to MSCI World.

On average, mega cap stocks lag behind but the market has clearly expressed a preference for such companies recently as this part of the market is dominated by the big defensive companies within consumer staples and healthcare. Brand name stocks are generally expensive and do not typically form part of a Value fund. Conversely, performance of small and mid caps have lagged and this has been a significant headwind for GAV.

Chart 3: Key size exposures as at 30 November 2008



Source: Schroders

Chart 4: Key regional exposures as at 30 November 2008

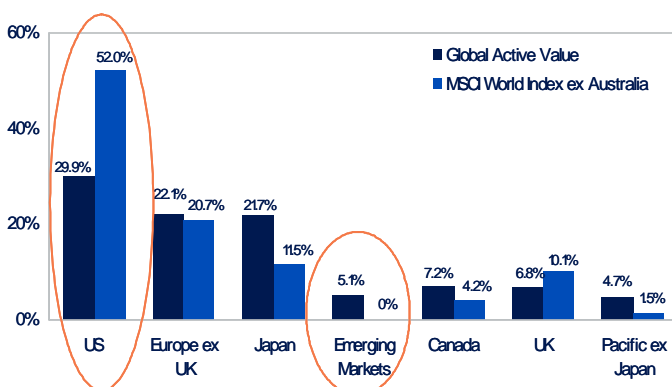


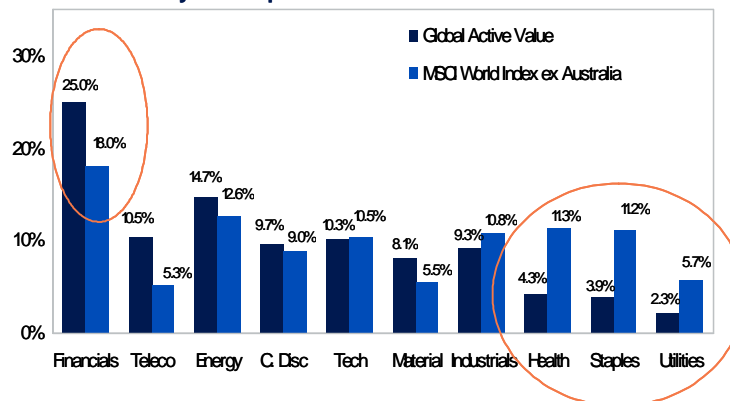
Chart 4 shows the key regional exposures for the strategy. It is immediately apparent that GAV has a huge underweight to US stocks which still trades at a premium to other markets. Also of note is the exposure to emerging markets. In recent months sentiment towards emerging markets has turned sour and investors have been pulling money out despite the fact that many of these markets still retain quite sound fundamentals.

Source: Schroders

Looking at sector exposures in Chart 5, the standout is the overweight to financials which have been one of the hardest hit sectors over the recent global financial crisis. The portfolio only holds very high quality companies within financials and did not hold Lehman Brothers, AIG, Merrills etc during the worst of the sub-prime crisis earlier this year.

Elsewhere, the Fund is underweight the 3 big defensive sectors (utilities, health and staples) which have outperformed strongly this year. These sectors have become relatively expensive hence the underweight exposures in the Fund.

Chart 5: Key sector exposures as at 30 November 2008



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Source: MSCI, Schroders

AUD returns to 30 November 08	1 year (%)
Schroder Global Active Value	-28.0
MSCI World ex Aus	-22.4
<b>Excess</b>	-5.6

AUD returns to 30 November 08	1 year (%)
Schroder Global Active Value (Hedged)	-47.0
MSCI World ex Aus hedged	-40.2
<b>Excess</b>	-6.8

Source: Schroders, MSCI

The Global Active Value strategy has underperformed by around 5-6% over the year to November 2008 with most of the underperformance occurring in the last 3 months. A key risk with this strategy is that performance can deviate quite significantly from market cap based benchmarks.

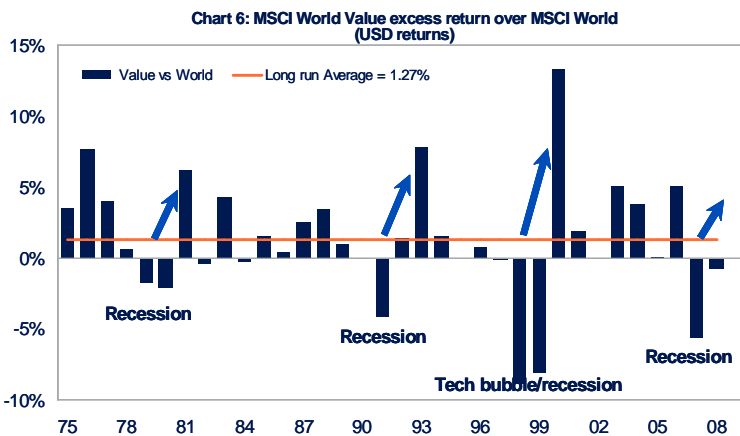
Removing the impact of currency, the MSCI World ex Australia hedged index returned -40.2% over the past year. Financials have declined by a massive -54.5%, emerging markets have fallen 48% and small and mid caps have clearly underperformed large caps. Global Active Value has experienced the perfect storm where all of these exposures have worked against the performance of the Fund.

Market returns to November 2008 (local)	1 year (%)
MSCI World ex Aus hedged	-40.2
MSCI World Financials	-54.5
MSCI Emerging markets	-48.0
MSCI World ex Aus Large cap	-39.0
MSCI World ex Aus Mid cap	-44.5
MSCI World ex Aus Small cap	-42.7
MSCI United States	-38.7

Source: Schroders, MSCI

This economic and market environment is indicative of a period of extreme risk aversion. Investors have been particularly severe in dumping the riskier asset classes. However markets always move in cycles and this period of underperformance is setting the strategy up for strong returns going forward.

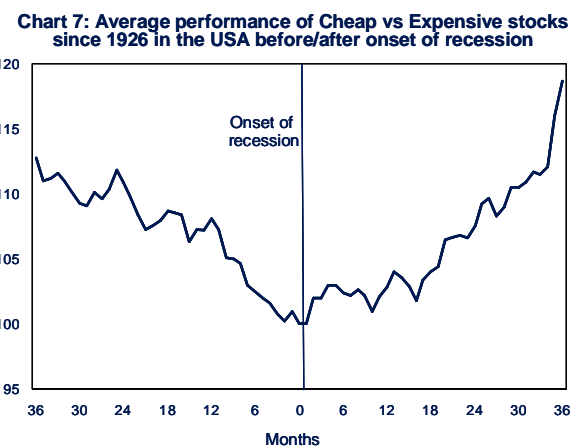
### Prospects for Value



Source: MSCI, Schroders

Chart 6 shows the relative performance of MSCI World Value vs MSCI World since 1975. Despite the challenging environment over the last two years, Value remains a winning long term strategy outperforming 3 years in every 4. Many studies show a premium attached to Value investing and it is during these times of distress that opportunities abound and set investors up for the next rebound. Periods of underperformance such as the recessions of 1980, 1990 and early 2000 have always been followed by strong outperformance. Investors need to constantly remind themselves of the importance of being contrarian.

Taking an even longer term perspective, Chart 7 shows the relative performance of a Value strategy in the US back to the 1920's, the benefit being that we can include no less than 13 recessions in the sample period. It is clearly apparent that Value underperforms as the economy turns down but then performs very well just after the onset of recession. This performance is particularly strong when valuation spreads are very wide – that is, the valuation gap in the market between the most expensive and cheapest stock is at an extreme as it is now.



Source: Schroders NBER, K. French, Based on 13 recessions since 1926. 'Cheap' based on a "High" minus "Low" Book Yield strategy.

### Outlook

The market backdrop of the past 2 years has not been conducive to Value as an investment style which has adversely impacted upon performance. However, this is entirely natural during a cyclical downturn and has happened many times before. The recent underperformance of Global Active Value is not out of line with previous cycles and is certainly not extreme.

History has shown us time and time again that recessions create investment opportunities and a Value strategy is one of the best ways of exploiting this over time. Indeed, it is the very source of the Value premium. As such, short term comparisons with the index are not necessarily helpful or useful which is why we firmly position the fund as a medium to long-term strategy. Whilst we expect the market to remain volatile in the short term as the economic news is digested, the market has not historically had to wait for evidence of recovery to start pricing one in. Typically, the best times to purchase value is at the nadir of recession.

A frequently cited phrase at moment is attributable to Warren Buffet says who argues that investors should be fearful when others are greedy and be greedy when others are fearful. That is the essence of Value investing.

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